

CRISIS IN INDIAN BANKING INDUSTRY

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“Free Enterprise was born with man
and shall survive as long as man
survives.”

— **A. D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

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* Dr. Dharmendra Bhandari

The banking sector is collapsing. The rate of recovery of advances to demand raised in public sector banks ranges from 15 percent to 50 percent in the Agriculture and Small Scale Industry (SSI) sector. In view of the huge Non-Performing Advances, the average rate of recovery in other sectors is also not likely to exceed 50 percent. **An indepth financial analysis and review without any qualifications or notes on accounts, would reveal that of the Rs.73,308 crores advanced by 20 nationalised banks as on March, 1990, at least Rs.35,000 crores are blocked in Non-Performing Advances. If a stock audit of the realisability of security is conducted objectively, the accumulated bad debts of banks will not be less than Rs.20,000 crores.**

Public faith in the banking sector has started eroding. The rate of growth of deposits in banks is declining. During April to September 1990, aggregate deposits of all scheduled banks rose by 7.4 percent, as against growth of 9.4 percent recorded during the corresponding period of 1989-90. If confidence is not restored in the economy and inflation is not contained, there may be a run on the banks for withdrawal

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of deposits. The deposits in nationalised banks as on March, 1990 were Rs.1,28,999 crores and even the Reserve Bank of India (RBI) may find it difficult to come to the banks' rescue in the event of panicky withdrawal of deposits.

The banks are holding a big share of deposits in the form of Central Government securities. These securities are held to meet unforeseen contingencies such as a run on the banks and for providing funds to the Government for developmental activities. Keeping in mind the resource position, it will not be possible for the Government to redeem these securities. The so called gilt-edged securities are only name sake since these have no buyers. The only recourse for the Government will be to ask RBI to print more notes. Technically, Banks will not get bankrupt since RBI will print notes and bail out the banks to honour the commitments of repaying the depositors.

The Deposit Insurance Credit Guarantee Corporation (DICGC) provides cover both for deposits and advances upto some small limits. However, the coverage will not practically be available in case of a large proportion of bank advances going bad and in the event of a run on the banks for withdrawal of deposits. Infact for the last five years the amount of payment of claims by the DICGC is more than the amount of premium collected. How long will the DICGC remain solvent is also a matter of conjecture?

The Profit and Loss Accounts of nationalised banks have started showing huge losses inspite of tremendous window dressing of the accounts. If an indepth financial review is done and adequate provision for bad and doubtful debts is made, the financial losses of all nationalised banks are likely

to run into several thousand crores of rupees. The Capital and Reserves of all the 20 nationalised banks would stand wiped out many times over.

The sickness in banking industry will cause a decline of economic activity. The banks have little funds to lend for new projects. Even the existing entrepreneurs will face difficulties in renewal of credit limits. This would further fuel inflationary process and with one unfavourable monsoon, the annual rate of inflation in India will be in three digits i.e., exceed 100 percent. Infact, the ugly phenomenon of severe credit restrictions has started emerging. The adverse impact of credit squeeze and hyper-inflation will totally erode the value of rupee.

Recovery of Advances in Doldrums

In the matter of recovery of advances, the commercial banks have to operate in an environment which is adverse to the bankers and generous to the defaulters. In case of default in payment of bank loans, the right to take possession of the hypothecated security is not available to the banks under any statutory provision even though such a right is provided for in the agreement of hypothecation. If the borrower refuses to give possession of the hypothecated security, the banks have no right to take forcible possession. The only remedy is to file a suit for recovery and obtain possession through the court. The credit institutions are even supposed to establish before a civil court that a debtor at all owes money to them. The delays and inefficiency of the civil judiciary in India in providing relief is known to all.

Suits by banks do not get any priority and by the time the suits come up for hearing, the securities deteriorate in value

or are stolen/transferred and the recovery is negligible. Expenses on litigation to be incurred by banks are very heavy, since the court fees are often as high as 10 percent of the amount claimed in the suit. In a large number of cases, the banks find that the borrower has sold the hypothecated security and neglected to deposit the sale proceeds for repayment of the loan. Although, prima facie the conduct of the borrower amounts to cheating, it is rarely that any borrower is punished for the offence.

Efforts by the banks for recovery have to be made more result oriented. The banks are custodians and trustees of funds representing the savings of millions of people. Recovery of advances made by the banks out of these funds is, therefore, in public interest and has to be accorded top priority. Financial institutions are given special powers of recovery. Section 29 of the State Financial Corporation Act, 1951, empowers the corporation to take possession of the assets of a defaulting unit and sell the same without the intervention of the court. A section similar to section 29 of the State Financial Corporation Act needs to be added in the Banking Regulation Act, to enable the banks to deal with recovery of loans and advances. The suggested amendment, if carried out, would empower the banks to take possession of the hypothecated assets of the borrower and sell them for recovery of their dues.

How can the Parliament be blind, after nationalisation of the banks, to the need for recovery of the money of the depositors lent out to loanees? The realisation of taxes imposed and assessed is done by thousands of assessing officers themselves at their own level as arrears of land revenue. To avoid an impending collapse of bank credit,

all branch managers themselves must be granted the legal power to realise the moneys as they become due by attaching and auctioning the assets belonging to the debtors without recourse to any authority outside the banking system. To eliminate the possibility of avoidable harshness in distress cases, a hierarchical body within the banking system, on the pattern similar to that existing in the tax system, can be permanently established with powers to provide relief in interest and staggering repayment of the principal.

Distortion of Accounts

The policy of the banks on Non Performing Advances and taking credit of interest income is also very tricky. Following the Reserve Bank of India Circular, the banks do not take to their income account interest on loans classified under Health Code 6, 7 and 8 (suit filed, decreed and bad / doubtful debts). However, so far as Health Code 4 and 5 (sick non-viable/sticky and advances recalled) are concerned, application of interest is suggested only on the prospect of realisability of the security. In case of Health Code 3 (sick but viable) the banks are allowed to credit interest. This entire approach encourages tremendous window dressing of accounts. Banks take credit of interest income in large number of cases on Advances classified in Health Code 4 and 5. Banks prefer to keep on postponing the filing of suit (Health Code 6) on the pretext of recovery and a large number of such advances have accumulated in Health Code 4 and 5. Even in respect of Health Code 3 (sick-viable/under nursing), there are several units which should correctly be classified to Health Code 4 (sick-non viable/sticky) which is also not done. There is ample scope for jugglery of Health Code classification.

In USA there exists an elaborate system of loan gradation. Under this system, loans are graded according to their recoverability. Therefore, the Balance Sheets of banks reveal a more realistic situation and the profits shown are more real than in India. In Canada, the banks directly include provision for loan losses in the income statements or a schedule thereto as a separate item for determination of their income for the period. India is an exception in the area. Provisions for bad and doubtful debts are never disclosed.

In several other developed countries also, banks indicate the accounting policies for loans, loan losses, provision for loan losses, interest, unearned discount etc. But the picture is very gloomy in India. The banks in India mention on the credit side of the Profit and Loss Account, Income (less provisions made during the year for bad and doubtful debts and other usual or necessary provisions) without disclosing the amount of provisions. Similarly, it is mentioned on the assets side of the Balance Sheet, Advances (other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors) without disclosing the actual provisions for loan losses.

Thus, in India there is no specific requirement to compel the banks to provide in full for bad and doubtful debts in the accounts. Disclosure of facts is the only way to build people's confidence on facts rather than mere conjecture. It is in the interest of depositors, Government, banking community and the public in general that capital and reserves of banks are adequate and prudent provisions are made against potential losses.

Loans and advances granted by banks are their assets and when banks are unable to recover interest thereon, the assets become non-performing assets. A non-performing asset in the banking sector is one that does not contribute to any income of the bank. In other words, it is a zero yielding asset. With the window dressing of accounts assuming large proportions, the need to disclose the factual position in the balance sheets is increasing. As a correct accounting practice, the banks should not take credit of interest income on advances classified under Health Code 3 to 8. The banks should classify in the Balance Sheet the advances as Performing (Health Code 1 and 2) and Non Performing Advances (Health Code 3 to 8). There is only one principle to be adhered to - take credit of income if the bank is earning it.

The correct accounts of the banks should be publicised adequately in order to create a proper climate of public opinion for taking remedial measures on the audit findings. The banking industry requires reinforcement not only from legislative enactments but also from public support and the public faith in the industry's capacity to protect public money.

Bank Audit - A Perfunctory Exercise

An interesting aspect of Bank Audit is the appointment of auditors. The banks enjoy the envious position that they have no auditors for nearly the entire year. It is only in the last week of March, the end of the Financial Year, that auditors are appointed to audit the accounts of the banks and thousands of their branches. The branch auditors are required to submit their reports by the end of April so that these may be consolidated at the Head Office, discussed

and approved by the Board of Directors and stamped by the auditors by mid May so that the Auditors' Report are sent to the President of India latest by June. Besides the time constraint, the fees paid to the auditors are so meagre that they are unable to do qualitative reporting - which is precisely what the Government desires!

The format of the Balance Sheet and Profit and Loss Account prescribed in Schedule III of the Banking Regulation Act have remained unchanged since 1949 when the Act was enacted. Taking into account the scope, perspective and objectives of the banks after nationalisation, there is a necessity for restructuring the format of the Balance Sheet, and the manner of presentation so as to give full and maximum information through the published accounts to the users. The need for disclosure of the correct financial position of the banks and effective accountability to the depositors has increased considerably over the years, especially with several countries falling into a debt trap.

Notes on Accounts - Distorting Transparency of Results

The golden rule of presentation of audit reports is that "facts should speak for themselves". The cause of audit is lost by default by the numerous Notes on Accounts since people's representatives do not possess the professional expertise to analyse the mass of material included in the notes in order to draw conclusions.

Even though, year after year, the country's commercial banks are reporting higher deposits, higher advances and higher profits, yet the balance sheets of the banks are causing lot of worry to the Government, possibly because

in recent times there is a perceptible manipulation in the presentation of financial results. Notes on Accounts have increasingly distorted the transparency of results. The contents of the financial statements of banks have been camouflaged and distorted over the years. The question that arises is: Can we call such statements true and fair?

In the bank's books, the value of security against advances continues to be shown so that provisions for bad debts are not made. The auditors absolve themselves of any responsibility by one simple note which appears year after year "the shortfall in realisation of advances, if any, that may arise in view of the basis of evaluation of advances has not been provided for, the quantum not being ascertainable." Thus one small note provides a big cover to the bank managements and also the auditors. As such, necessary provision for bad debts to the tune of several hundred crores in each bank is not being made.

A major form of distortion and an important cause of decline in quality of financial statements is the extent of use of notes appended to the Profit and Loss Accounts and Balance Sheets. Over the 20 years period since the nationalisation of Banks in 1969, the number of notes on accounts in banks have increased from 46 to over 300. The analysis of financial statements of public sector banks are at present a futile exercise which is good neither for practical use nor for research purposes. Parliament representing the public is also fed with the same information/data and is therefore no better placed than the public itself.

Shyness in Disclosure

The air is thick with promises of an open polity, economy and administration. There is a general acceptance of the

value of fair reporting. In this enlightened environment should the reporting of the banks remain an anachronism? As fair reporting brings with it motivation, increased competitiveness, comparability and credence, disclosure of banking realities is the only way to boost people's confidence. However, there seems to be little concern for a correct reporting of financial statements of commercial banks. The particulars of bad debts are not revealed in the Balance Sheets of banks. The banks are reluctant to treat an advance as bad although by all means it is irrecoverable simply to take credit of interest income on such advances and book profits in the accounts although no real income is earned.

The amount and name of the loanee from whom money lent has become irrecoverable is a secret jealously guarded by the banking establishment. Divulging such information, it is said, is against the tenets of confidential relationship between a bank and its customers. This instance of nationalised banks quoting some archaic nineteenth century rule of British banking to avoid scrutiny of their activities should not cut much ice. Since public accountability is involved, the banks cannot get away by simply invoking the rule of confidentiality. It is a feeble argument that once banks begin to disclose the amount and name of the loanee from whom money lent has become recoverable, their clients will go elsewhere. The clients have nowhere else to go; all the important Indian banks are nationalised banks.

The top hundred defaulters of every bank in terms of their amount and age-wise overdues need to be disclosed by the bank in their Balance Sheets for information of the depositors. The management should indicate in their explanatory note,

the efforts made in the matter of recovery and the results obtained during the relevant year to retrieve their money.

While it is understandable that banks do not disclose the size and ownership of deposits for the simple reason of securing all kinds of money - good or bad - into the banks; there is little justification for not disclosing the defaulter's identity and the extent of loss being incurred through him. In the international monetary world, the banking system and the creditor countries, are merciless in exposing and working against not only on actual default but too often long before that eventuality against the potential defaulters. Is India, not having a feel of that treatment from her foreign creditors inspite of the fact that she has never defaulted in making payment to the creditors?

The Government of India and State Governments could also claim to have a relationship of confidentiality with their banker, which happens to be the Reserve Bank of India. However, that did not deter the then Union Finance Minister from stating publicly how much overdraft each State had run up with the RBI. Obviously, there is no reason for treating a business tycoon with greater deference than what is shown to a State Government. If that calls for a change of banking statute, the Government must arrange to pass the necessary amendment swiftly.

Comptroller and Auditor General — A Bystander to the Collapsing Banking Sector

It is being increasingly felt that the Comptroller and Auditor General (CAG) should conduct supplementary audit of important institutions like the Reserve Bank of India, State Bank of India, nationalised banks, Life Insurance Corporation

and similar other financial institutions. However, the offers of successive Comptroller and Auditors General in this regard were rejected by the Government. For instance, the audit of Life Insurance Corporation is conducted by professional firms of Chartered Accountants and the CAG has been totally excluded in respect of its audit or even supplementary audit. The reason given by the Government was that the audit of Life Insurance Corporation requires special knowledge of actuarial sciences and the staff of CAG does not possess the technical knowledge to conduct the audit of this corporation. It is a shame that the supreme audit institution of the country has been presumed by the Government to be lacking actuarial knowledge while a firm of Chartered Accountants supposedly possesses the same. Should not the CAG have protested against such strictures? Audit can only reflect political will. The popular will in the parliamentary system is reflected by the elected Government. The initiative for strengthening audit should come from the people and the parliament.

The Committee on Paper Laid on the Table of the Rajya Sabha in its eighth report in 1983 opined thus: Considering the huge funds and vast financial transactions involved in the nationalised banks, it is desirable to utilise the expertise of the Comptroller and Auditor General so that the independence of audit and accountability to Parliament are ensured fully. The Committee finds no plausible reason why the audit of public sector banks should not be brought under the Comptroller and Auditor General. The committee recommends that early steps may be taken by the Government in this regard either by a change in the procedure adopted or by modifying the existing provisions of the Acts, wherever necessary.

In its fifteenth report in 1984, the committee felt 'more than convinced about the soundness of its earlier recommendation for bringing the audit of the public sector banks under the Comptroller and Auditor General of India. The committee reiterated that early steps be taken by the Government in this regard to ensure a better and higher standard of accounting and accountability for the banking institutions in public sector.'

There is a need for the CAG to do an indepth financial review and conduct 'Value for Money Audit' and to report to the Parliament whether the banks are adequately discharging their financial responsibilities, the amount of the depositors are gainfully utilised, the various schemes are being executed efficiently, economically and producing the results expected of them. The Audit Report of the CAG will then automatically be discussed by the Financial Committees of the Parliament. Control over the purse is the touchstone of Parliamentary form of Government.

Parliamentary Scrutiny — A Cry in the Wilderness

In a democratic set up, the power of the purse resides with the Parliament. In India, this control is exercised through the Financial Committees of Parliament. The financial committees act as miniature Parliament as the various political parties get proportional representation thereon. While the Parliament works on party lines, the financial committees work on non partisan basis.

Unfortunately, the machinery for enforcing public accountability has broken down. The absence of effective financial discipline in India is a major obstacle to the optimisation of resources that are available to improve the standard of living of the common man.

The Estimates Committee of the seventh Lok Sabha regretted lack of information available for examining the working results of public sector banks. For example, the committee expressed surprise that the reporting system as devised by the Reserve Bank of India gave information of recovery of agricultural advances only and not about advances granted to other sectors of the economy. The Finance Secretary assured the Committee that "RBI had prescribed a new format and when data about other sectors of economy starts flowing in, a complete picture of recovery performance of banks would become available." It is more than 10 years since the assurance was given but even now the information is not made available to the financial committees. The only plausible reason for not providing the information in respect of recovery of loans granted in sectors other than agriculture is that the rate of recovery to demand raised is alarmingly poor from medium and large industries. Successive Finance Secretaries in the Government of India apparently prefer to keep the skeleton in the cupboard only to be discovered by their successor.

The financial committees of the Parliament have time and again desired to know the amount of bad and doubtful debts and the provisions made therefor to ascertain the correct working results and performance of the bank. The Parliamentary Committees are refused information because banks claimed statutory protection from divulging such information. The committee unanimously expressed the view that after nationalisation, banks have become accountable to parliament and the names of the defaulters and amount of bad and doubtful debts could no longer be kept secret and should even be disclosed in the banks annual report. To this, the Finance Secretary assured in evidence that the question of providing information to financial committees is under

examination of a committee under the Chairmanship of the Deputy Governor of RBI. Can there be a situation more dangerous than that in which a bureaucrat decides whether the Supreme Parliament, even after persistent request, should be informed or not? The unanimous recommendation of the financial committee was "The Committee would await a decision on the findings and recommendations of this Committee" (Eighty-Fourth Report of Estimates Committee 1983-84, page 67 para 6.22). The point here is - Who is the trustee of taxpayers' money? Can it happen in any business that an executive refuses to divulge the financial information in respect of his organisation to his master? To put it bluntly, it is precisely a situation where the owner (Parliament) has left the financial management of the nation to the 'Munims' knowing well that there is a large scale diversion of public funds for the personal advantage of a few. The price being paid is heavy. The citizens of India are being robbed and the nation is becoming poorer and poorer. What Shakespeare said "Dear Brutus, the fault is not in thy stars but in ourselves, that we are underlings", perhaps, applies to the Parliament and people of India!

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

“People must come to accept private enterprise not as a necessary evil, but as an affirmative good.”

— **Eugène Black**

FORUM OF FREE ENTERPRISE

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